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UNCLAS SECTION 01 OF 04 BRASILIA 002939

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SUBJECT: UPCOMING SHAKEOUT IN BRAZILIAN CIVIL AVIATION

¶11. (U) THIS CABLE IS BASED UPON INPUT PROVIDED BY ECON AND FCS SECTIONS AT AMEMBASSY BRASILIA, AMCONSULATE SAO PAULO, AND AMCONSULATE RIO DE JANEIRO.

¶12. (SBU) SUMMARY. DESPITE RISING PASSENGER LOADS IN THE BRAZILIAN CIVIL AVIATION MARKET, TWO CARRIERS - VARIG AND VASP, WHICH TOGETHER ACCOUNT FOR 40% OF THE BRAZILIAN MARKET - ARE STRUGGLING TO SURVIVE. VASP WILL HAVE GREAT DIFFICULTY MAKING IT PAST THE END OF THE YEAR. VARIG, CURRENTLY THE LARGEST CARRIER IN THE MARKET, IS COUNTING ON A GOVERNMENT BAILOUT, ALTHOUGH WHATEVER GOB ASSISTANCE IS FORTHCOMING WILL LIKELY BE INSUFFICIENT TO ENSURE ITS VIABILITY IN THE MEDIUM-TERM. WITH THE LULA ADMINISTRATION DETERMINED TO CURB SPENDING, AND WHATEVER LOOSE CHANGE IT CAN COME UP WITH LIKELY DESTINED FOR SOCIAL WELFARE PROGRAMS AND PUBLIC INFRASTRUCTURE DEVELOPMENT, THE GOB HAS NEITHER THE MEANS NOR THE DESIRE TO MOUNT A FULL-FLEDGED RESCUE PACKAGE. IF VARIG IS TO SURVIVE, ULTIMATELY A CASH-RICH OUTSIDE INVESTOR WILL HAVE TO PURCHASE A STAKE IN THE COMPANY AND NEGOTIATE A SETTLEMENT WITH THE CARRIER'S CREDITORS. END SUMMARY.

CLEAR SKIES BUT WITH PATCHES OF TURBULENCE

¶13. (U) BASED ON RECENT STATISTICS, THE BRAZILIAN CIVIL AVIATION INDUSTRY IS ENJOYING A GOOD YEAR. JANUARY TO AUGUST 2004 FIGURES SHOW THAT THE NUMBER OF PASSENGERS TRANSPORTED INCREASED 11.4 PERCENT COMPARED TO THE CORRESPONDING PERIOD LAST YEAR, AND DOMESTIC SALES FOR 2003 STOOD AT 8.78 BILLION REAIS - UP FROM 7.98 BILLION IN 2002. AS A WHOLE, THE SECTOR WENT FROM A DEFICIT OF 698 MILLION REAIS IN 2002 TO A PROFIT OF 368 MILLION IN 2003. NOTWITHSTANDING THESE POSITIVE OVERALL RESULTS, TWO PRIVATE SECTOR BRAZILIAN CARRIERS - VARIG AND VASP - ARE IN DEEP TROUBLE.

VASP'S TROUBLES

¶14. (U) ONCE RESPONSIBLE FOR 36 PERCENT OF THE BRAZILIAN MARKET AND IN COMMAND OF A FLEET OF 62 AIRCRAFT, NOW VASP IS HOUNDED BY CREDITORS AND BARELY FUNCTIONING. CURRENTLY, THE CARRIER HAS ONLY 17 PLANES IN-SERVICE, NO INTERNATIONAL ROUTES, AND A MERE 8.6 PERCENT OF THE MARKET. THE COMPANY HAS DEBTS OF NEARLY 3 BILLION REAIS (OVER USD 1 BILLION), AND RECENT HIKES IN FUEL PRICES HAVE ONLY MADE THE CARRIER'S SITUATION EVEN MORE PRECARIOUS. ITS PILOTS PERIODICALLY GO ON STRIKE BECAUSE OF UNPAID BACK WAGES, CAUSING THE MASS CANCELLATION OF THE AIRLINE'S FLIGHTS. AS A RESULT, TRAVEL AGENCIES HAVE SHIED AWAY FROM BOOKING CLIENTS ON VASP, AND THE AIRLINE'S LOAD FACTOR HAS FALLEN TO 49 PERCENT (THE NATIONAL AVERAGE IS 68 PERCENT). THE NATIONAL AIRPORT AUTHORITY (INFRAERO) IS DEMANDING CASH UP FRONT TO PAY LANDING FEES PRIOR TO ANY FLIGHT DEPARTING, AND HAS THREATENED TO BAR VASP PLANES FROM FLYING IF THE AIRLINE DOES NOT MAKE ITS ACCOUNT CURRENT. VASP OWES INFRAERO ALONE 774 MILLION REAIS. UNABLE TO FIND ANY BANK WILLING TO LEND THE COMPANY MONEY, VASP OWNER WAGNER CANHEDO HAS SOLD HOTEL PROPERTIES HE OWNS AND EVEN CATTLE FROM HIS RANCH TO PAY DEBT.

¶15. (SBU) EARLIER IN THE YEAR, THE GOB CIVIL AVIATION AUTHORITY (DCA) RECENTLY GROUNDED 6 OF VASP'S 737-200S FOR HAVING SURPASSED STRUCTURAL SAFETY LIMITS, AND LACKING IN MONEY TO PAY MAINTENANCE THE CARRIER HAS HAD TO WITHDRAW OTHER AIRCRAFT FROM ITS ACTIVE FLEET. CURRENTLY, VASP IS STUCK FLYING ELDERLY AIRCRAFT (ITS FLEET HAS AN AVERAGE AGE OF 25 YEARS), WHICH, ACCORDING TO ITS COMPETITORS, ONCE NEW GOB ALTITUDE SEPARATION RULES (RVSM) GO INTO EFFECT JANUARY 1, WILL NOT HAVE THE NECESSARY EQUIPMENT TO FLY SAFELY OVER 30,000 FEET. THIS LAST PROBLEM COULD WELL BE THE DEATH KNELL FOR VASP AS THE COST OF EQUIPPING THE CARRIER'S AGING AIRCRAFT WITH RVSM WOULD BE PROHIBITIVE, WHILE THE EXTRA FUEL COSTS ASSOCIATED WITH FLYING UNDER 30,000 FEET WOULD

MAKE THAT ALTERNATIVE EQUALLY UNATTRACTIVE.

VARIG'S WOES

16. (SBU) VARIG'S SITUATION, WHILE NOT AS DIRE, IS SERIOUS AS WELL. THE PRESS REPORTS THAT THE COMPANY IS MIRED IN 7 BILLION REAIS WORTH OF DEBT, A GOOD CHUNK OF WHICH IT IS UNABLE TO SERVICE GIVEN THAT THE COMPANY CONTINUES TO RUN LOSSES. ACCORDING TO ONE INDUSTRY SOURCE, MUCH OF VARIG'S DEBT MOUNTAIN IS DUE TO MISMANAGEMENT AS COMPANY OFFICIALS NEGLECTED TO HEDGE THEIR DOLLAR-BASED LOANS PRIOR TO THE SHARP DECLINE OF THE REAL IN THE LATE 1990S. AN OFFICIAL FROM ONE COMPETITOR AIRLINE NOTED THAT, NOTWITHSTANDING RECENT BELT-TIGHTENING, VARIG WOULD NEED 20 YEARS OF EXCELLENT PROFITS (WITH NONE OF ITS RETAINED EARNINGS CHANNELED TOWARDS INVESTMENT) TO PAY OFF WHAT IT NOW OWES. VARIG IS IN HOCK NOT ONLY TO BOEING, GE (LEASEHOLDERS OF ITS AIRCRAFT), AND JAPANESE AND EUROPEAN BANKS, BUT TO ITS EMPLOYEE PENSION FUND AS WELL. ALTHOUGH THE PENSION FUND BOOKS SHOW A NOMINAL VALUE OF 2.3 BILLION REAIS, ABOUT HALF OF THIS AMOUNT STILL HAS TO BE PAID IN BY THE COMPANY. VARIG FURTHER SUFFERS FROM HIGH FIXED COSTS AS A RESULT OF ITS BLOATED EMPLOYEE ROLLS. ACCORDING TO ONE INDUSTRY CONTACT, THE COMPANY HAS 200 EMPLOYEES PER AIRCRAFT - WHILE ONE OF ITS CUT-RATE COMPETITORS FIELDS A RATIO OF 98 EMPLOYEES PER AIRCRAFT.

TOO BIG TO FAIL?

17. (SBU) ONE ADVANTAGE THAT VARIG HAS (WHICH VASP DOES NOT) IS SIZE. WHILE VASP HAS A WORK-FORCE OF 4,400 EMPLOYEES, VARIG EMPLOYS ALMOST 20,000 WORKERS, PROVIDES MORE THAN HALF OF THE JOBS IN THE DOMESTIC CIVAIR INDUSTRY, AND BRINGS MORE THAN USD 1 BILLION IN FOREIGN EXCHANGE INTO THE COUNTRY. WITH THE COMPANY'S EXTENDED REACH, IT HAS A READY-MADE CONGRESSIONAL BLOC INTERESTED IN ENSURING THE CARRIER'S SURVIVAL. INDEED, THE LOCAL PRESS REPORTS THAT ONE PROPOSAL CURRENTLY CIRCULATING IN CONGRESS (AND WHICH PURPORTEDLY HAS THE SUPPORT OF 272 SENATORS/DEPUTIES) WOULD SEEK TO RESTRUCTURE THE AIRLINE, WITH OUTSTANDING SUPPLIER/PENSION FUND DEBT BEING CONVERTED TO SHARES AND MONIES OWED TO THE GOB BEING RENEGLIOTATED. WHETHER THE GOB SHARES CONGRESS' ENTHUSIASM FOR SEEKING TO BAIL OUT VARIG, HOWEVER, IS ANOTHER MATTER.

18. (SBU) WHILE THERE HAVE BEEN A PLETHORA OF RUMORS OVER THE PAST FEW MONTHS THAT THE GOB IS CONSIDERING A RESCUE PACKAGE FOR VARIG, SO FAR THE LULA ADMINISTRATION HAS NOT PUT FORWARD ANY PROPOSAL. THE DEPARTURE OF DEFENSE MINISTER VIEGAS IN EARLY NOVEMBER LIKELY SLOWED GOB DECISIONMAKING AS REGULATION OF CIVIL AVIATION FALLS UNDER THE MINISTRY OF DEFENSE. STILL, ANOTHER LINE OF THINKING IS THAT THE GOB WILL WAIT UNTIL VASP GOES BUST PRIOR TO UNVEILING ANY PACKAGE SO IT THAT IT WON'T BE CALLED ON TO BAIL OUT THAT CARRIER AS WELL. BASED ON MISSION CONVERSATIONS WITH GOB OFFICIALS, IT IS CLEAR THAT, IDEALLY, THE GOVERNMENT WOULD LIKE VARIG TO SURVIVE (VASP ALREADY BEING SEEN AS A LOST CAUSE) BUT IS NOT QUITE SURE WHAT STEPS TO TAKE TO MAKE THIS SO.

THE OPTIONS

19. (SBU) IN POST'S VIEW, IN THE ABSENCE OF ANY UNFORESEEN NEGOTIATED OFFERS COMING FROM THE PRIVATE SECTOR, THERE ARE THREE BROAD COURSES OF ACTION THAT THE GOB CAN TAKE WITH RESPECT TO VARIG. FIRST, IT COULD MOUNT A FULL-FLEDGED EFFORT TO SAVE THE AIRLINE AT ALL COSTS. SUCH A PACKAGE COULD INCLUDE: A) CUT-RATE FINANCING FROM THE GOB'S NATIONAL DEVELOPMENT BANK (BNDES), B) PRESSURING LOCAL PENSION FUNDS TO INVEST IN THE AIRLINE, C) SEARCHING OUT POTENTIAL FOREIGN PARTNERS, D) SETTLING AN OUTSTANDING LAWSUIT BY VARIG SO AS TO INJECT FURTHER CASH INTO THE COMPANY, AND E) MANIPULATING THE CIVAIR REGULATORY REGIME TO BENEFIT VARIG.

110. (SBU) COMPETITORS COMPLAIN THAT THE LOCAL CIVIL AVIATION AUTHORITY (DCA) HAS TO SOME EXTENT ALREADY ENGAGED IN THE LAST STEP AS IT HAS DELAYED APPLICATIONS BY COMPETITORS TO OBTAIN NEW LEASED AIRCRAFT WHILE EXPEDITING SIMILAR APPLICATIONS BY VARIG. HOWEVER, TAKING MORE AMBITIOUS STEPS IN THIS REGARD (SUCH AS EXPLICITLY DIVIDING UP THE MARKET AND CHANNELING PROFITABLE ROUTES TO VARIG) WOULD RAISE BOTH LEGAL AND ANTI-TRUST CONCERNS. IN 2003, CADE - ONE OF THE GOB'S ANTI-TRUST ENFORCERS - INDICATED THAT IT WOULD TAKE A CLOSE LOOK AT A PROPOSED TAM-VARIG MERGER. AS TAM, WHICH HAS SEEN ITS REVENUES INCREASE AS THE MARKET EXPANDS, NOW APPEARS TO NO LONGER BE INTERESTED IN THE DEAL, THAT PROPOSED FUSION NOW LOOKS TO BE DEAD (ALTHOUGH ON CERTAIN ROUTES TAM-VARIG CODESHARES LIVE ON).

111. (SBU) PERHAPS THE BEST ARGUMENTS AGAINST AN AGGRESSIVE BAIL-OUT WERE ENUNCIATED BY ONE PLANALTO INSIDER THE AMBASSADOR SPOKE TO. WHY SHOULD A GOVERNMENT HEADED BY A

WORKER'S PARTY PRESIDENT SUBSIDIZE A POORLY-MANAGED FIRM WHICH SERVES THE ELITE (THE POOR DON'T HAVE ENOUGH MONEY TO FLY) WHEN IT DOES NOT SUBSIDIZE THE MODES OF TRANSPORT (BUS/METRO) MOST USED BY THE WORKING CLASS, HE ASKED RHETORICALLY? ALL THIS AT A TIME WHEN THE GOB IS SQUEEZING EXPENDITURES TO THE MAXIMUM EXTENT POSSIBLE TO PUT ITS FISCAL HOUSE IN ORDER. BESIDES, OUR CONTACT ADDED, VARIG'S SITUATION WAS SO GRAVE THAT IT WAS LONG PAST THE TIME WHEN ANY FINANCIAL PACKAGE COULD BE REASONABLY EXPECTED TO KEEP THE COMPANY ALOFT FOR ANY LENGTH OF TIME.

¶12. (SBU) ANOTHER OPTION AVAILABLE TO THE GOB IS TO SIMPLY SIT ON ITS HANDS, I.E., DECLINE TO ASSEMBLE A RESCUE EFFORT AND LET THE MARKET DETERMINE THE COMPANY'S FATE. UNDER THIS SCENARIO, TAM, GOL, AND BRA - ALL WELL-RUN AIRLINES - WOULD TAKE OVER VARIG'S MARKET SHARE AND POSSIBLY EVEN HIRE A PORTION OF VARIG'S WORKFORCE. NEVERTHELESS, THIS COURSE WOULD EXPOSE THE GOB TO POLITICAL HEAT FROM BOTH THE CONGRESS AND THOSE WHO LOST THEIR JOBS, AND LIKELY IS NOT THE SOUND-BITE PRESIDENT LULA WOULD DESIRE FOR HIS REELECTION CAMPAIGN IN 2006.

¶13. (SBU) ONE OFFICIAL FROM A COMPETITOR AIRLINE TOLD US THAT IF VARIG WERE TO GO BANKRUPT, THEN HE EXPECTED THAT THE DOMESTIC MARKET WOULD IMMEDIATELY SHAKE OUT WITH GOL AND TAM EACH ASSUMING A 40 PERCENT SHARE, AND BRA SERVING THE REMAINING 20 PERCENT. OVERSEAS, HOWEVER, VARIG'S QUICK DEATH WOULD MEAN THAT BRAZIL WOULD LOSE ITS MOST WELL-KNOWN INTERNATIONAL CARRIER. WHILE TAM, GOL, AND BRA HAVE TAKEN INITIAL STEPS TO ESTABLISH THEMSELVES ABROAD, NONE OF THEM CURRENTLY HAS THE INSTANT NAME RECOGNITION NEEDED TO ATTRACT LARGE NUMBERS OF FOREIGN PASSENGERS. NOR, SHOULD VARIG ABRUPTLY CEASE OPERATIONS, WOULD THEY BE ABLE TO QUICKLY RAMP UP TO GET THE NECESSARY SLOTS INTO CROWDED AIRPORTS IN THE U.S. AND EUROPE. FOREIGN CARRIERS, THEREFORE, WOULD LIKELY FILL THE VOID LEFT BY A QUICK VARIG EXIT - A RESULT WHICH THE GOB WOULD CERTAINLY SEEK TO AVOID.

¶14. (SBU) THE THIRD PATH THE GOB MIGHT PURSUE IS TO OFFER UP A PARSIMONIOUS, HALF-HEARTED RESCUE PLAN - INCORPORATING ONE OR MORE OF THE ELEMENTS OUTLINED IN PARAGRAPH 9 ABOVE --DESIGNED TO PROLONG THE PERIOD BEFORE WHICH VARIG DECLARES BANKRUPTCY. THIS, ONE WELL-CONNECTED VARIG SUPPLIER TOLD US, WOULD MIMIC THE GOB'S EARLIER RESPONSE TO THE EMERGENCE OF FINANCIAL PROBLEMS IN THE NOW-DEFUNCT TRANSBRASIL AIRLINES AND IS THE TRADITIONAL BRAZILIAN WAY OF HANDLING SUCH MATTERS. UNDER THIS SCENARIO, VARIG WOULD NOT CEASE OPERATIONS UNTIL AFTER THE FALL 2006 PRESIDENTIAL ELECTIONS AND TAM, GOL, AND BRA WOULD, IN THE INTERIM, HAVE TIME TO READY THEMSELVES FOR THE INTERNATIONAL MARKET. WHILE THE FINANCIAL COST OF KEEPING VARIG ALIVE UNTIL FALL 2006 IS UNCLEAR, A LIMITED TWO-YEAR REPRIEVE WOULD CERTAINLY BE CHEAPER THAN A RESCUE EFFORT DESIGNED TO RETURN THE AIRLINE TO GOOD HEALTH. GIVEN THE DRAWBACKS OF ALL THE OTHER COURSES OF ACTION AND THE LIMITED FINANCIAL IMPLICATIONS THIS OPTION WOULD POSE FOR THE TREASURY, POST BELIEVES THAT, ABSENT THE SUDDEN EMERGENCE OF A PRIVATE SECTOR SUITOR, THIS IS THE PATH THAT THE GOB WILL EVENTUALLY ADOPT.

¶15. (SBU) COMMENT. THE DILEMMA THE GOB FACES IS A FAMILIAR ONE: WHETHER TO RESCUE A KEY INFRASTRUCTURE PROVIDER FROM THE CONSEQUENCES OF ITS OWN BAD DECISIONS OR WHETHER TO INSTEAD LET THE MARKET DETERMINE THE COMPANY'S FATE. UP TO NOW, THE GOB HAS KEPT IS POWDER DRY, ALTHOUGH SOONER OR LATER IT WILL HAVE TO COME TO A DECISION. AS THERE IS NO GOOD OPTION HERE FOR THE LULA ADMINISTRATION, IN THE END IT WILL SIMPLY HAVE TO DECIDE WHICH IS THE "LEAST BAD" ALTERNATIVE.

CHICOLA